

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
HILL DRIVE RENTAL CO., INC. }

Appearances:

For Appellant: C. Barry Abbott
Certified Public Accountant

Victor J. Backus, President

For Respondent: Richard A. Watson
Counsel

-O-P-I-N-I-O-N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Hill Drive Rental Co., Inc., against a proposed assessment of additional franchise tax in the amount of \$3,493.15 for the income year ended June 30, 1968.

Appellant, a California corporation formed on July 13, 1964, is engaged in the operation of the San Gabriel Convalescent Center. On June 30, 1968, the end of its fiscal year, two entries were made in appellant's "Allowance for Bad Debts" account. The purpose of the entries, which reflected a \$31,301 credit to the account, was to increase the reserve for estimated bad debts "as determined by management". One month later, on July 31, appellant charged \$12,571.89

Anneal of Hill Drive Rental Co., Inc.

against the reserve to reflect debts which were uncollectible. In March 1969, appellant filed its franchise tax return for the income year ended June 30, 1968, and deducted the \$31,301 as an addition to its reserve for bad debts. Thereafter the federal government audited appellant's returns for several years including the year in issue. Based upon the federal audit report, respondent revised appellant's taxable income upward from \$28,441 to \$78,345, an increase of \$49,904.

Appellant, although not contesting the federal audit adjustments, protested respondent's proposed assessment on the basis that its reserve for bad debts was not properly adjusted for the income year ended June 30, 1968. Specifically, appellant asserted that as of that date a reserve of \$84,487 was necessary to cover doubtful accounts. However, the adjustment by the Internal Revenue Service limited the balance in appellant's reserve account to only \$34,616. Therefore, appellant argues its income for that year was overstated by \$49,871, the difference between the amount allowed by the Internal Revenue Service as a bad debt reserve and the amount of receivables allegedly uncollectible.

The sole question for determination is whether appellant may retroactively increase its reserve for bad debts.

Section 24348, subdivision (a), of the Revenue and Taxation Code allows a taxpayer to reflect its bad debt expense by either of two mutually exclusive methods; by the specific charge off of debts which actually become worthless during the year, or by a reasonable addition to a reserve for bad debts. If the taxpayer elects the reserve method, the estimate of the bad debt reserve required for any year must be measured by the conditions as they reasonably appear at the time the estimate is made. Where the taxpayer has charged the current annual addition to its reserve for bad debts and deducted such amount in that year's return it may not in a subsequent year, retroactively, deduct an additional amount. In such a situation, the added amount would *not* be a reasonable addition to the reserve account as of the year in question and is, therefore, not allowed. (Farmville Oil & Fertilizer Co. v. Commissioner, 78 F.2d 83; Rogan v. Commercial Discount Co., 149 F.2d 585, cert. denied, 326 U.S. 764 [90 L. Ed. 460]; Rio Grande Building & Loan Association, 63 T.C. 657.)

Appeal of Hill Drive Rental Co., Inc.

In both Commercial Discount Co. and Rio Grande the taxpayer contended that it should be allowed, retroactively, to increase its reserve for bad debts. In both cases it was argued that since the taxpayer would have been allowed the increased deduction had the book entries been made in the previous year it should be allowed to correct the books to reflect the proper amount in the later year. In both cases the court disallowed the claimed deduction. The basis for the disallowance was that the taxpayer was bound by its determination made at the end of the taxable year in issue as to what was a reasonable addition to its reserve account notwithstanding the fact that it would have been entitled to a greater deduction had a larger reserve been determined necessary at that time. (Rogan v. Commercial Discount Co., supra; Rio Grande Building & Loan Association, supra.)

Here, appellant is in an even weaker position than the taxpayers in Commercial Discount Co. and Rio Grande since the additions to its reserve during the year in question, for which a deduction was allowed, were more than adequate to absorb the losses incurred during that period. The record indicates that by July 31, 1968, only \$12,571.89 in actual bad debts had been charged against the reserve leaving a balance of over \$30,000. In fact, by June 30, 1969, the balance of the reserve account exceeded \$123,000.

In conclusion it is our opinion that appellant may not retroactively increase its reserve for bad debts. Respondent's determination in this matter must therefore be sustained.

O R D E R

Fursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Hill Drive Rental Co., Inc., against a proposed assessment of additional franchise tax in the amount of \$3,493.15 for the income year ended June 30, 1968, be and the same is hereby sustained,

• Appeal of Hill Drive Rental Co., Inc.

Done at Sacramento, California, this 16th day
of January, 1973, by the State Board of Equalization.

Delbert G. Smith, Chairman
Robert Speer, Member
John W. French, Member
Paul K. Brown, Member
_____, Member

ATTEST: *W. W. Rempel*, Secretary